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October 21, 1997

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Dear Mike,

I am following up on my conversation with you of a few weeks ago. Now that we have had several weeks of experience dealing with the new version of Appendix A to Rule 15c3-1, we wanted to clarify that the applicability of the rule to one particular strategy is not significantly different now than it was before September 1. For the purpose of this letter, the examples given assume the use of the alternative strategy based method. Note, however, that our comments apply to the risk based haircut method since the definition of underlying instrument embodied in subparagraph (a)(4) of Appendix A appears to apply to either method

The problem we are concerned with relates to the term "full amount of conversion loss" as it is used in that subparagraph. There are many instances where an option position is totally or partially hedged even without simulating a conversion which in the real world would not occur.

For example, a broker-dealer buys a bond at a price of 110. Each bond is convertible at \$10 par value of the bond per share into 100 shares of common stock that has a market price of 5. In effect, by owning the bond when its value is 110, the owner can buy stock at a net cost of \$11 per share. Simultaneously the broker-dealer sells for 1/4 a call option with an exercise price of 15.

The downside risk of owning the bond is comprehended by its normal haircut. By selling the call option, the broker-dealer has mitigated some of the downside exposure in return for which he has forfeited some of the benefit he would derive if the stock were to ever rise beyond 15. The way we see it, the haircut on the call should be zero, or -\$25 after considering the addback of its value.

The reason for this is that based upon the current situation, since the conversion value of the bond is 50, were the underlying stock to ever rise to 15, the bond would have to be valued at that point in time at at least 150 and would continue to cover the risk in the call beyond that point.

A literal, but I believe inappropriate, reading of the new version of Appendix A would cause the reader to calculate a haircut on this hedged bond position which would be much greater than the haircut on the bond standing on its own. The artificial conversion loss of \$600 would be offset by the \$25 premium received for the call, which when added to the \$75 haircut on the stock position resulting from the conversion would thus yield a haircut of \$850. Treating the bond and the call option as unhedged positions would result in a bond haircut of \$165, plus an option haircut of \$250 less the \$25 premium. Clearly, both of these

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treatments are inappropriate to the point of being punitive for a broker-dealer establishing a hedge to limit its risk.

I am confident that you would agree that an appropriate way of evaluating for haircut purposes a call option that is hedged by a convertible security is to compare the strike price of the call to the greater of the conversion price multiplied the price of the convertible issue, or the actual stock price. Thus for a bond trading at 110 that is convertible at \$10 per share, any call option sold against it would reference the greater of the converted stock price of \$11, or the actual price of \$5. To the extent that the call option had a strike price above \$11, there should be no haircut on the option (except for adding back the time value) since there is no risk. Thus the combined bond and option position would be subject to a capital charge of 15% of the value of the bond (I assume the bond is not investment grade or sells for 100 or more for this purpose), less the time value of the call.

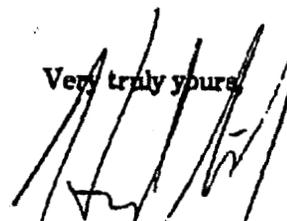
To the extent that the strike price is below \$11 but above the current market price of the underlying stock, the haircut on the combined bond and option position (after adding back the time value) should reflect the conversion loss limited to difference between the converted stock price and the strike price, plus a haircut on the simulated stock position. In the instant situation, had the call option had a strike price of \$10, the conversion loss exposure to be taken into account is \$100 and the haircut on the simulated stock position (the value of the bond net of the conversion loss) should be 15% of \$1,000 or \$150, less the time value of the call.

To the extent that the strike price is below the current price of the underlying stock, the haircut on the combined bond and option position (after adding back the time value) should reflect the entire conversion loss, plus the normal haircut on the simulated stock position, less the excess of the current market value over the exercise value. Assuming a call option with strike of \$4 and a market price of \$1.50, the conversion loss of \$800 would be offset by the time value of \$50 and the in the money amount of \$100 and would be added to a 15% haircut on \$500 or \$75 for a total net capital exposure of \$525. In this instant case, an astute person might choose to calculate the bond haircut and option haircut as if the positions were unhedged resulting in a lower haircut ($\$1,100 @ 15\% = \165 for the bond, plus \$250 minimum on the option less the time value of \$50)

I would appreciate hearing back from you very soon on this issue which has just now become apparent as a result of applying the revised subparagraph. Please feel free to call me at any time.

Thank you.

Very truly yours,



(Howard Spindel)
Managing Director

HS:ab
cc: Mark Steffensen
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